

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Nunez Analyst: Scott McFarlane Bill Number: ABX3 9  
Related Bills: See Legislative History Telephone: 845-6075 Amended Date: March 10, 11, & 12, 2008  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Petroleum Surtax / Oil Severance Tax

### SUMMARY

This bill would impose a surtax on California net income that arises from business activities in the petroleum industry, and a severance tax on oil extracted in California.

The State Board of Equalization (BOE) would administer the severance tax. Accordingly, that provision of the bill would not impact this department and is not addressed in this analysis.

### SUMMARY OF AMENDMENTS

The bill as introduced on February 4, 2008, and as amended on February 7, 2008, was a spot bill.

The March 10, 2008, amendments added the petroleum surtax and oil severance tax provisions. The March 11, 2008, and March 12, 2008, amendments made changes to the oil severance tax provisions. This is the department's first analysis of this bill.

### PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to generate new revenue from windfalls enjoyed by oil companies and apply that revenue for California educational purposes.

### EFFECTIVE/OPERATIVE DATE

As an urgency measure, this provision would be effective immediately upon enactment. The bill specifies that it would apply for taxable years beginning on or after January 1, 2008.

### POSITION

Pending.

### SUMMARY OF SUGGESTED AMENDMENTS

The definition of "Gross business receipts" for corporate taxpayers would apply only to apportioning corporations. Amendments 1 through 10 are suggested to broaden the definition of "Gross business receipts" so that it would apply to both apportioning and non-apportioning corporate taxpayers.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Selvi Stanislaus

5/15/08

## ANALYSIS

### FEDERAL/STATE LAW

#### *Specific Oil and Gas Industry Provisions*

#### **Background**

Prior federal law in effect from 1980 to 1988 imposed an excise tax on certain oil windfall profits. The tax rate ranged from 15% to 70% of the difference between the market price of oil and a predetermined base price. Currently, there is no federal tax on oil windfall profits. California has no history of enacted legislation imposing a state-level windfall profits tax.

#### **Current Law**

Existing federal and state income tax laws contain provisions unique to taxpayers in the oil and gas industry.

Federal provisions that California conforms to include:

- Intangible Drilling Costs (IDCs). IDCs are perhaps misnamed because they are anything but “intangible.” They are specific and real drilling cost outlays associated with oil and gas operations. Examples of IDCs range from the clearing of ground, draining, and surveying work to prepare for the drilling of wells to wages, fuel, repairs, supplies, chemicals and cement incident to and necessary in the drilling and preparation of wells for the production of oil and gas. Generally speaking, expenditures are classified as IDCs if they have no salvage value.

Taxpayers have the option to capitalize IDCs, immediately expense IDCs in the year incurred, or amortize the IDCs over 60 months.

- *AMT Preference Item*. Excess IDCs are treated as a preference item for alternative minimum tax purposes. The “excess” is the difference between the allowable IDC deduction over the amount that would have been allowable had the IDCs been capitalized and depreciated using a straight-line method.
- Cost or Percentage Depletion. Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset – in the case of depletion for oil or gas interests, the mineral reserve itself – is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. For example, the costs of acquiring the lease or other interest in the property are recovered through depletion deductions.

There are two types of depletion methods:

- *Cost Depletion.* Under the cost depletion method, the deduction is computed by the ratio of units sold in the year over the total number of units that the property is expected to produce. The amount recovered under cost depletion may never exceed the taxpayer's basis in the property.
- *Percentage Depletion.* Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction each year. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

Federal-only and California-only provisions include:

- *Federal Only - Geological & Geophysical (G&G) Amortization.* G&G costs, sometimes referred to as exploration costs, are those costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and/or retention of mineral properties by taxpayers exploring for minerals such as oil. G&G costs incurred in connection with oil and gas exploration in the United States by independent producers and smaller integrated oil companies<sup>1</sup> may be amortized over two years. Major integrated oil companies are required to amortize G&G costs over seven years for amounts paid or incurred after December 19, 2007.
- *California Only – Single-Weighted Sales Factor.* There is an exception to the double-weighted sales factor for certain business activities, including those activities relating to the production, refining, or processing of oil and gas. Such activities are subject to an apportionment formula with a single-weighted sales factor.

### *General Corporate Franchise Tax*

Existing California law imposes a franchise tax, measured by net income, on every corporation doing business in this state, whether organized in-state or out-of-state. The corporation franchise tax rate is 8.84%. The S corporation franchise tax rate is 1.5%.

California law also imposes an income tax on corporations that are not doing business in California, but are deriving income from California sources. The tax rates are also 8.84% and 1.5% for general corporations and S corporations, respectively.

### *Personal Income Tax*

California law imposes an income tax at rates ranging from 1% to 9.3%, on individuals, estates, and trusts.

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<sup>1</sup> Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

## THIS BILL

This bill would impose a 2% surtax on individuals and business entities, including corporations, engaged in business activities in the petroleum industry. The surtax would apply to net income in excess of \$10 million. The surtax would be in addition to, but treated the same as, the current personal income tax or corporation franchise and income tax.

The term “taxpayer engaged in business activities in the petroleum industry” would mean a taxpayer that has more than 50% of its “Gross business receipts,” as defined, derived from conducting one or more qualified business activities. Those activities would include petroleum producing, refining, wholesaling and retailing activities, as described in specified sections of the North American Industry Classification System (NAICS) Manual published by the United States Office of Management and Budget, 2007 Edition.

In the case of a unitary group required to be included in a combined report, the 50% test would apply at the group level.

In the case of pass-through entities (PTE), the bill specifies that the 50% test would apply at both the entity and investor level. An investor in a PTE that meets both the 50% test and has net income in excess of \$10 million would be subject to the surtax on the investor’s distributive or pro-rata share of that income. In addition, any PTE that engages in petroleum activities must separately state the gross business receipts of those activities regardless of whether the 50% test is met at the entity level. If an investor in a PTE meets the 50% test, the investor would be required to aggregate its distributive or pro-rata share of net income for all the investor’s PTEs – to the extent the PTE net income did not exceed the \$10 million threshold at the entity-level – along with the investor’s net income from other sources for purposes of applying the \$10 million threshold at the investor level.

This bill would authorize FTB to issue rules and regulations.

## TECHNICAL CONSIDERATIONS

The definition of “Gross business receipts” for corporate taxpayers would apply only to apportioning corporations. A California-only corporation (or a combined unitary group of California-only corporations) may argue that the “Gross-business-receipts” 50% test does not apply to them. Amendments 1 through 10 are suggested to broaden the definition of “Gross business receipts” to apply to both apportioning and non-apportioning corporate taxpayers.

## IMPLEMENTATION CONSIDERATIONS

This bill would require modification of existing individual and business entity tax forms and instructions for computing and reporting the surtax. This bill also would require modification of systems, including the individual and business entity accounting, nonfiler, return processing, and cashiering systems, to account for and issue assessments of the additional tax.

Most of these changes could be accomplished during the normal annual update.

## **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

None of the states surveyed impose a surtax on taxpayers engaged in petroleum industry business activities.

## **LEGISLATIVE HISTORY**

AB 2442 (Klehs, 2005/2006) would have imposed a 2% surtax on net income that arises from the business activities in the petroleum industry. The petroleum surtax provisions in AB 2442 were similar to this bill, but the effective dates were different. AB 2442 failed passage on the Assembly floor.

AB 673 (Klehs, 2005/2006) would have imposed a 2.5% tax on the windfall profits of petroleum producers and refiners. The bill failed passage on the Assembly Floor.

ABX 128 (Corbett and Wiggins, 2001/2002) and ABX2 2 (Corbett and Wiggins, 2001/2002) were identical. These bills would have imposed a tax on excess gross receipts from electrical energy distribution and required electricity purchasers to withhold and remit the tax. SBX 128 was held in the Assembly Appropriations Committee. ABX2 2 failed passage on the Assembly floor.

SBX 1 (Soto, 2001/2002) and SBX2 1 (Soto, 2001/2002) would have imposed an Electricity Windfall Profits Tax on sellers of electricity and would have refunded the amount collected to individuals that filed a tax return. SBX 1 was held on the Assembly when the first extraordinary session ended. SBX2 1 failed passage on the Assembly floor.

SB 14 (Thompson, 1995/1996) and SB 1777 (Burton, 1999/2000) would have imposed a Petroleum Windfall Profits Tax on certain taxpayers engaged in petroleum refining. SB 14 failed passage in the Assembly Revenue and Taxation Committee. SB 1777 was held in the Senate Rules Committee.

## **FISCAL IMPACT**

The department estimates it would cost approximately \$220,000 to make programming and processing changes in the first year. In subsequent years, this bill would not significantly impact the department's programming and processing costs.

## ECONOMIC IMPACT

### Revenue Estimate

Based on data and assumptions discussed below, the petroleum surtax provisions of the bill would result in the following revenue gains.

Revenue Impact of <u>Petroleum Surtax</u> Provision of AB X3 9 Enactment Assumed After June 30, 2008 (\$ in Millions)		
2008/09	2009/10	2010/11
+ \$230	+\$220	+ \$200

This analysis does not account for changes in employment, personal income, or gross state product that could result from this provision.

### Revenue Discussion

Micro-level data on a sample of California petroleum producers, refiners, wholesalers, and retailers was used to estimate the revenue impact of this proposal. The state net incomes (SNIs) of these taxpayers were obtained for 2005 and projected into the future using financial information from public-domain sources and expert judgment. A surtax of 2% was then applied to the excess of SNI in any taxable year over \$10,000,000. It was assumed that this proposal would be enacted sometime after June 30, 2008.

For the 2008 taxable year, excess SNIs for California corporate petroleum producers, refiners, wholesalers, and retailers is forecast <sup>2</sup> to be approximately \$9 billion resulting in \$180 million (\$9 billion × 0.02) of tax revenue. The inclusion of personal income taxpayers would add another 5% to the revenue impact resulting in a total gain for the first fiscal year of approximately \$190 million.

The \$190 million revenue for the 2008 taxable year, as well as the revenue for subsequent taxable years, is converted to fiscal year revenue impacts in the revenue table above.

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<sup>2</sup> Projected income for 2008 is based on data published in The Value Line Investment Survey.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO ABX3 9  
As Amended March 12, 2008

AMENDMENT 1

On page 4, strikeout lines 28 to 32.

AMENDMENT 2

(1) On page 4, line 33, strike out "(2)" and insert:

AMENDMENT 3

On page 4, lines 37-38, strike out "within an apportioning trade or business"

AMENDMENT 4

On page 4, line 39, strike out "income and apportionment factors" and insert:

income, or income and apportionment factors, as the case may be,

AMENDMENT 5

(2) On page 5, line 3, strike out "(3)" and insert:

AMENDMENT 6

(3) On page 5, line 7, strike out "(4)" and insert:

AMENDMENT 7

On page 5, line 11, strike out "income and apportionment factors" and insert:

income, or income and apportionment factors, as the case may be,

AMENDMENT 8

On page 5, line 15, strike out "(4)" and insert:

(3)

AMENDMENT 9

On page 5, line 16, after entire, strike out "apportioning"

AMENDMENT 10

On page 5, line 21, after paragraph, strike out "(4)" and insert:

(3)